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SUBJECT: CORPORATE BONDS: ISRAEL'S "SUBPRIME CRISIS"

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Summary

¶1. (SBU) Gil Buffman, the Chief Economist at Bank Leumi, says that the GOI is only now waking up to the trouble in the Israeli corporate bond market. The problems were brought on by deregulation and the import of the global financial criQQQ 1QQQQQavings funds have been rather mild, he nonetheless supported establishing a safety net for holders of these funds. He advocated the use of the 2003 U.S.-Israel Loan Guarantee Agreement to raise funds for government efforts in these and other areas. Eyal Klein, formerly the Debt Division Chief at the Ministry of Finance (MOF) and now the Chief Economist at IBI Investments strongly opposed the use of the LGA funds, saying it would send the wrong message to the markets about the state of the Israeli economy. (Comment: if the USG ever makes further deductions from the Loan Guarantee money available to Israel due to Israel's continued spending on West Bank settlements, the argument between the two economists may be moot, as there would be too little of the LGA funds left to matter. End Comment.)

¶2. (U) Buffman thinks the GOI did not act quickly enough to deal with the crisis. The Bank of Israel (BOI) is finally on track, substantially lowering interest rates. He favors increasing unemployment benefits and keeping the scheduled 2009 income tax cuts in place. He says that Israel is still in the interim stage and has not yet been hit full force by the global financial crisis. He foresees 2009 growth slowing to two percent, the deficit rising to about 2 - 2.5 percent and inflation near zero. He also thinks that exports will be flat.
End Summary.

Corporate Bond Market in Trouble

¶3. (U) At a recent meeting with Dep EconCouns, Gil Buffman, the Chief Economist at Bank Leumi, one of Israel's two biggest banks, said that his greatest concern was the situation in Israel's corporate bond market, which he called "the weakest part of the economy," characterizing the problem in that market as "Israel's subprime crisis." Bank Leumi has long been concerned about the health of that market, but Buffman said that Ministry of Finance and Bank of Israel officials dismissed these concerns when he raised them. He said that the financial indicators in that market had been deteriorating, with the spreads becoming very low. This indicated that something was "deeply wrong with the pricing of risk in the market." The interest being paid on the bonds issued by risky ventures was barely higher than on lower-risk bonds.

Bachar Reforms Deregulated Risk

¶4. (U) While the Bachar capital market reforms implemented over the past few years have recently been subjected to withering criticism, Buffman faulted them mostly in connection with the corporate bond crisis. As a result of the reforms, pension and long-term savings plan money management moved from relatively conservative banks to considerably less conservative institutional investors, who promised investors high returns in a short period of time. These institutions were very creative in the way they catered to the business sector, coming up with various sorts of risky corporate bond offerings. However, these largely unregulated institutions did not sufficiently consider risk in any of its manifestations -- market, legal, operational, or credit.

Transfer of Ownership without Responsibility

¶5. (U) Buffman characterized the shift in money management from the highly regulated banks to these unregulated institutions as "a transfer of ownership without a transfer of responsibility." As a result, the corporate bond sector evolved very quickly and institutional investors bought bonds with little thought about risk. Prior to this period, business borrowings were about 80 to 90 percent from banks. With the reform, corporate customers left the banks and found easy financing elsewhere. Buffman added that the banks also took advantage of the situation, encouraging their riskier clients to find their credit solutions elsewhere, which they

did.

Real Estate Crisis Comes to Israel

¶6. (U) Regarding some of the "tycoons" in the real estate market who invested heavily in other countries, Buffman said they got hit by inflation in various countries and by the high value of the shekel, which hurt them as they converted their profits from foreign currency. The increase in commodity prices was also a negative factor. Their investments, whether in Las Vegas and Arizona, or Russia and Eastern Europe - all of which are now getting hammered -- were mostly in non-residential construction, including office and retail space. The global real estate crisis came to Israel via this drastic decline in the value of their holdings. About one third of Israel's corporate bonds were issued by companies involved in real estate, which gives an idea of the dimensions of the problem. Buffman thought it not unreasonable to assume that some of these companies would fail. He said that the banks will be increasing provisions for doubtful debt, and will likely try to continue to diversify their portfolios by doing more business with households and smaller businesses. An advantage of bank credit is that it can be renegotiated when necessary. Bonds lack that flexibility, another factor which contributes to the likelihood of substantial default rates. Buffman forecast about a five percent default rate for corporate bonds in the coming period.

Safety Net OK

¶7. (U) Buffman noted that holders of corporate bonds and of pension and long-term savings accounts are exerting enormous pressure for the government to take action to provide a safety net with a guaranteed minimum rate of return for their investments. He was supportive of the concept, saying that a safety net would provide a greater degree of certainty and end the tendency of the public to panic in the face of harsh economic news. This would also reduce the incentive to withdraw funds, engendering further stability. However, the mechanism for establishing safety nets is complex. One suggestion Buffman had was for the government to take steps to increase liquidity for institutions. He cited the example of a government bonds buyback program in 1995, during which institutional

investors were allowed to sell government bonds prior to maturity without incurring penalties.

Pension Funds Not That Badly Hit

¶8. (U) Regarding the breathless newspaper reporting about huge losses in the value of these funds - which is generating the demands for a safety net, Buffman said that the funds have declined in the last year by about 9-15 percent, with the higher risk ones down by about 20 percent. In the present difficult financial environment, institutional investors are selling low-risk government bonds to increase desperately-needed liquidity. While foreigners have been pulling out of the Israeli markets, Israelis have been bringing a substantial amount of money back home, resulting in a net inflow of portfolio investment. Buffman added that foreign investors are unlikely to return to the Israeli market until after the February Knesset elections, when the political situation stabilizes.

Support the Corporate Bond Market

¶9. (U) Buffman said that the government could consider purchasing corporate bonds. Noting, however, that the USG has backed away from this concept, he said that this is probably not the best way to address the root of the problem. The MOF has also stated that it does not plan to intervene in the corporate market. (Note: Bank of Israel [BOI] Governor Stanley Fischer said on November 13 that the government should not intervene in the corporate bond market. He said that the fact that a company was able to borrow money during good times does not justify intervention by the government to help it in less prosperous times. As long as the market is functioning regularly, as it is currently, intervention is not necessary or desirable. End Note.)

Use the Loan Guarantees

¶10. (U) Buffman supports having the government advance credit for

specific sectors in a sort of matching process with the banks. For every shekel that the banks would provide, the government would provide a shekel of earmarked credits. He also suggested that money remaining in the 2003 the U.S.-Israel Loan Guarantee Agreement (LGA) be used to raise money abroad to finance directed credit through the banking system. He said that this would improve the situation in numerous sectors and also allow for extending credit terms form, for example, 120 to 180 days. When asked if the use of the LGA money would have a negative impact on the international perception of Israel's credit-worthiness, he said that it probably would. However, he added that it was worth doing regardless, as the perception would likely become reality if the problem were not properly addressed.

Another Economist Says Don't Use LGA

¶11. (SBU) At a separate meeting, when Dep EconCouns asked Eyal Klein, formerly the Chief of the MOF Debt Division, and now the Chief Economist at IBI Investment House, about the use of the LGA money, Klein was adamantly against it. He said that it is known that Israel views the LGA money as a sort of "rainy day fund," to be used "only in the case of dire need." Therefore, the extremely negative message that would be sent about Israel's economic situation would far outweigh whatever little good would come from using the money still available under the loan guarantee program. (Comment: if the USG ever makes further deductions from the Loan Guarantee money available to Israel due to Israel's continued spending on West Bank settlements, the argument between the two economists may be moot, as there would be too little of the LGA funds left to matter. End Comment.)

GOI Didn't Act Quickly Enough

¶12. (U) Buffman felt that the GOI should have acted earlier in its handling of the crisis. He was disappointed with the lack of contingency planning in both the MOF and the Bank of Israel, saying that they are six months behind where they should be. Despite thinking that the Israeli economy was in good shape and not endangered by the international financial upheaval, Israel's economic leaders should have taken seriously and addressed public fears with regard to their savings programs early on.
Buffman said that the senior management of the bank would be meeting, at the government's request, to formulate its recommendations on how to deal with the overall economic situation.

Interest Rate Policy Finally on Track

¶13. (U) On interest rate policy, Buffman said that the BOI is finally on the right track, after a long period of failing to do the right thing. The recent surprise cuts in interest rates indicate that the BOI finally realized that something had to be done. He thinks that more cuts are in the offing -- perhaps another 100 to 200 basis points. Regardless, he praised BOI Governor Fischer as an important stabilizing factor in the Israeli economy, who is now proving himself.

Additional Suggested GOI Actions

¶14. (U) Buffman dismissed as totally ineffectual a recent MOF plan to allow fund managers to value three percent of the bond holding they plan to hold to maturity at their maturity values rather than having to mark them to market for valuation purposes. While this would mask some short-term losses, this was simply a palliative, which did nothing to deal with the problem and, in any case, affected very little of the money under management. He did, however, favor increasing unemployment benefits, and/or extending the benefit period for people continuing to actively seek work. On the issue of the long-planned income tax reductions scheduled for 2009, he opposed delaying them, for fear of sending a negative message that the situation is worse than it really is. He also said that the government was remiss in only providing an implicit guarantee of the security of bank deposits via public statements by senior officials that no one would lose money deposited in bank accounts. He thinks that the guarantee should have been made explicit as soon as problems arose a few months ago, and that the banks should participate in bearing the cost through the payment of

insurance premiums.

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GOI is the Obstacle to Infrastructure Spending
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¶15. (U) Buffman was against the original Ministry of Finance economic plan. He said it would not be effective, and the Knesset would not approve it in any case. The plan's call for a NIS 10 billion investment in infrastructure is "wonderful," but will not have much impact in the coming months. He maintained that finding financing for infrastructure spending is not a problem, even in economically difficult times. The problem is the bureaucratic obstacles the government puts in the way of getting projects approved and moving. Regardless, such projects cannot stimulate the economy much in the short-run as they are very time consuming and take years to get off the ground and pay off.

Israel Still OK but Crisis Coming

¶16. (U) Israel is now in an interim stage, waiting for the financial crisis to hit the real economy with full force. However, he shares the widely-accepted view that the country is doing relatively well, and is not being affected as much by the crisis as other developed and emerging economies. This is due to strong fundamentals, including the responsible economic policy of the last few years, the current account surplus, and a relatively high rate of household savings - 12 percent of net income. Only France has a higher rate, while in the U.S., the savings rate has been close to zero. The reason for this is that employees make extensive use of automatic savings plans, and have significant portions of their salaries automatically deposited into pension funds, long-term savings (provident) funds, and educational training funds. These savings instruments also have tax benefits. Buffman contrasted these mandatory savings plans with the situation in the U.S., where participation in such plans is not automatic as it is in Israel.

2009 Economic Forecast

¶17. (U) Buffman forecast two percent growth in 2009, and 3 - 3.5 percent growth in 2010. He thinks there will be a significant slowdown, but not like the severe recession of 2001-2002, which was exacerbated by the confluence of numerous events which all hit at the same time: the Intifada, the hi-tech bust, and September 11, ¶2001. On exports, Buffman said that there would have been negative growth in 2009 if not for the new USD 2.5 billion Intel plant that will soon come on line and begin exporting during the year. He thinks that the deficit in 2009 will be 2 - 2.5 percent, which is lower than many other estimates. However, he noted that the implementation of a pension safety net and directed credit would raise the deficit. Given lower commodity prices and the economic slowdown, Buffman foresees no inflation in 2009, and does not rule out mild deflation.

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